SMSF Owners' Alliance
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SMSFOA Members' Newsletter

#11 /2014

Dear Members

This will be the final SMSFOA Newsletter for 2014. We take the opportunity to thank all members for your support during the year. When you are meeting friends and colleagues over the summer holiday break please take the opportunity to tell them about us and suggest they become members of SMSFOA. The more members we have, the stronger our voice will be.

Best wishes of the season to all.

Unpacking the Financial System Inquiry's Final Report

Of course, the big news of the past week has been the release of David Murray's final report from the Financial System Inquiry.

SMSFOA's Research Director, Malcolm Clyde, attended the lock-up on Sunday morning for a sneak preview and we then issued a media release summarising the main elements and pointing out that the really important issues for SMSFs – such as taxation of retirement earnings – have been referred to next year's Tax White Paper. **Click here to go to the media release.**

Two of our members provided comment to the media on how they saw the report affecting SMSFs – David Rohr in *The Australian* and Greg Angelo in the *Financial Review, the Sydney Morning Herald* and the *Melbourne Age*. **Their stories are here.**

SMSFOA was also interviewed on ABC *NewsRadio.*

A list of FSI recommendations is here**. (See attachment at end of this Newsletter)** You can also read the full report at: www.fsi.gov.au/publications/

SMSFs hardly mentioned, but very much in the firing line

Curiously, in a 300+ page report we could find only two references to self-managed superannuation funds – both merely noting that SMSFs did not need the same prudential regulation as the large APRA funds.

However, a couple of recommendations were of relevance to SMSFs and some of the FSI's 'observations' that will be referred to the forthcoming Tax White Paper may have a very significant impact on SMSF owners.

The major APRA-regulated funds may be wishing they did not get so much attention – drawing strong criticism in the FSI report over the costs they charge to their members and lack of transparency in their governance.

One interesting recommendation from the FSI was that an objective should be set for the superannuation system – a point we have also made.

It is curious that a $1.8 trillion 'industry' has developed over two decades without an over-arching public policy objective.

As the FSI says, defining the purpose of superannuation and enshrining it in legislation will:

- Provide a framework for evaluating the efficiency and effectiveness of the superannuation system
- Contribute to greater long-term confidence and policy stability through agreed objectives, against which superannuation policy proposals can be assessed.

The idea is that once the objectives are set proposals for change will have to be tested against them and it will be harder for governments to change the goal posts when it suits them.

The simple objective recommended by FSI: *"To provide income in retirement to substitute or supplement the Age Pension"* is supported by subsidiary objectives, notably:

"Alleviate fiscal pressures on the Government from the retirement income system."

These 11 words contain huge implications for superannuation generally and SMSFs in particular.

The report says superannuation tax concessions are not well targeted at improving retirement incomes and it talks about aligning the earnings tax rate between the accumulation and retirement phases.

This would entail a restructuring of the taxation of superannuation.

As did the interim report, the final report makes much of the fact that the bulk of superannuation tax concessions go to the top 20% of income earners. However, again the FSI failed to take into account that the same top 20% of income earners pay the bulk of income tax. Their tax concession is in proportion to the tax they pay.

Clearly the FSI report is lining up SMSF owners for a tax hit via the White Paper. This is consistent with the Treasury's agenda to wind back super tax concessions.

The FSI Report canvasses two options for better targeting tax concessions. It says *"Both options would limit tax concessions for individuals with large superannuation balances."* Here, they mean people with SMSFs. The options are:

1. Reduce the non-concessional contribution cap (currently $540k over 3 years) and better target superannuation contribution tax concessions. The report argues that reducing the extent to which individuals can accrue very large balances would help to better target tax concessions.
2. Levy additional earnings tax on superannuation account balances above a certain limit. The report acknowledges similar proposals in the past have not succeeded due to their complexity and high costs of implementation.

As we have consistently said in our submissions to government, changes to the superannuation system may be desirable and necessary to ensure the long term viability of the system. There is merit in changing from the current TTE model (tax on contributions and earnings but not on earnings in retirement) to an EET system (no tax on contributions and earnings but retirement income is taxed) as applies in many countries. More people are beginning to recognise this may be the best outcome for Australia in the long term.

Such fundamental report of the system will need to be considered carefully and implemented in a way that does not penalise people who have built their retirement savings under the current rules.

SMSF owners must ensure any review of the superannuation system and its taxes is thorough, objective and includes grandfathering.

If anyone needs a reason why the SMSF Owners' Alliance is necessary, this is it.

Other significant issues raised in an attachment to the FSI report and referred to the Tax White Paper are:

- Reducing negative gearing and capital gains tax concessions

and

- Reviewing dividend imputation

Of course, changes to dividend imputation could have a major impact on SMSF owners who rely on franked dividends for income.

An interesting proposal in the FSI Report is that superannuation funds should be required to offer their members retirement income products (e.g. annuities). While the FSI says this would not apply to SMSFs, we'll need to keep an eye on this one. While SMSFOA is in favour of the market providing retirement income products to assist people to plan their finances in retirement, we also firmly hold the view that investment in these products should not be mandatory.

Borrowing by SMSFs – yes or no?

The only recommendation from the FSI that will directly affect some SMSFs is that gearing for direct investment (e.g. property, shares) should be banned in the future. The FSI is concerned that although borrowing by super funds (read SMSFs) is relatively small compared with total assets (currently 1.8% of assets), it is growing rapidly and may pose systemic risk in the future. There is also concern that some people are being encouraged by property spruikers to set up an SMSF to buy a highly leveraged property.

There appear to be two schools of thought on this issue:

First, that gearing within a super fund is risky and not compatible with a conservative investment strategy to deliver a sustainable income in retirement.

Second, that gearing is an appropriate strategy in individual circumstances provided it is done sensibly and does not overload a super fund with debt. For example, small business owners may want to hold their business premises within their SMSF. Other investors may see borrowing as a way to build assets in their fund, particularly if they haven't been able to save enough.

It is generally agreed that having a single, highly geared asset in an SMSF is risky and should not be encouraged even though it might work for some. Solutions to this problem are tougher action against miss-selling by unlicensed and unscrupulous promotors (ASIC has recently taken court action against one); credit limits (APRA is warning the banks to wind back their property lending); and education of investors.

In our FSI submission we suggested that valid concerns about borrowing by SMSFs could be met by limiting gearing to 50% of an asset. This would cut out the dodgy practice of persuading people to set up an SMSF to borrow heavily to buy over-priced residential property, leaving them vulnerable to rising interest rates and dips in the property rental market.

If you have views on this question, we'd like to hear them. Send your comments to: info@smsfoa.org.au

The ATO reviews a good year for SMSFs

The ATO has just released a review of SMSFs in the past year, noting that the number of Australians with SMSF accounts passed one million for the first time. It's worth a read as there is useful advice on the ATO's approach to LRBAs and other issues. **Click here to see the report.**

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ATTACHMENT

FSI Final Report Recommendations and Tax Observations

7 December 2014

	Recommendation
1	**Capital Levels** *Set capital standards such that Australian authorised deposit-taking institution capital ratios are unquestionably strong.*
2	**Narrow mortgage risk weight differences** *Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.*
3	**Loss absorbing and recapitalisation capacity** *Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.*
4	**Transparent reporting** *Develop a reporting template for Australian authorised deposit-taking institution capital ratios that is transparent against the minimum Basel capital framework.*
5	**Crisis management toolkit** *Complete the existing processes for strengthening crisis management powers that have been on hold pending the outcome of the Inquiry.*
6	**Financial Claims Scheme** *Maintain the ex post funding structure of the Financial Claims Scheme for authorised deposit-taking institutions.*
7	**Leverage ration** *Introduce a leverage ratio that acts as a backstop to authorised deposit-taking institutions' risk-weighted capital positions.*
8	**Direct borrowing by superannuation funds** *Remove the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds.*
9	**Objective of the superannuation system** *Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.*
10	**Improving efficiency during accumulation** *Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.*
11	**The retirement phase of superannuation**

	Require superannuation trustees to pre-select a comprehensive income product for members' retirement. (CIPR) The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.
12	**Choice of fund** *Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.*
13	**Governance of superannuation funds** *Mandate a majority of independent directors on the board of corporate trustee of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.*
14	**Collaboration to enable innovation** *Establish a permanent public-private sector collaborative committee, the "Innovation Collaboration", to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.*
15	**Digital identity** *Develop a national strategy for a federated-style model of trusted digital identities.*
16	**Clearer graduated payments regulation** *Enhance graduation of retail payments regulation by clarifying thresholds for regulation by ASIC and APRA.* *Strengthen consumer protection by mandating the ePayments Code. Introduce a separate prudential regime with two tiers for purchased payment facilities.*
17	**Interchange fees and customer surcharging** *Improve interchange fee regulation by clarifying thresholds for when they apply, broadening the range of fees and payments they apply to, and lowering interchange fees.* *Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging.*
18	**Crowdfunding** *Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.*

19	**Data access and use** *Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.*
20	**Comprehensive credit reporting** *Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.*
21	**Strengthen product issuer and distributor accountability** *Introduce a targeted and principles-based product design and distribution obligation.*
22	**Introduce product intervention power** *Introduce a proactive product intervention power that would enhance regulatory toolkit available where there is risk of significant consumer detriment.*
23	**Facilitate innovative disclosure** *Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.*
24	**Align the interests of financial firms and consumers** *Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structure in life insurance and stockbroking do not affect the quality of financial advice.*
25	**Raise the competency of advisers** *Raise the competency of financial advice providers and introduce an enhanced register of advisers.*
26	**Improve guidance and disclosure in general insurance** *Improve guidance (including tools and calculators) and disclosure for general insurance, especially in relation to home insurance.*
27	**Regulator accountability** *Create a new Financial Regulator Assessment Board to advise Government annually on how financial regulators have implemented their mandates.* *Provide clearer guidance to regulators in Statements of Expectation and increase the use of performance indicators for regulator performance.*
28	**Execution of mandate** *Provide regulators with more stable funding by adopting a three-year funding model based on periodic funding reviews, increase their capacity to pay competitive remuneration , boost flexibility in respect of staffing and funding, and require them to undertake periodic capability reviews.*
29	**Strengthening ASIC's funding and powers** *Introduce an industry funding model for ASIC and provide ASIC with stronger regulatory tools.*
30	**Strengthening the focus on competition in the financial system** *Review the state of competition in the sector every three years, improve reporting of how regulators balance competition against their core objectives, identify barriers to cross-border provision of financial services and include consideration of competition in ASIC's mandate.*
31	**Compliance costs and policy processes**

	Increase the time available for industry to implement complex regulatory change. *Conduct post-implementation reviews of major regulatory changes more frequently.*
32	**Impact investment** *Explore ways to facilitate development of the impact investment market and encourage innovation in funding social service delivery.* *Provide guidance to superannuation trustees on the appropriateness of impact investment.* *Support law reform to classify a private ancillary fund a s 'sophisticated' or 'professional' investor, where the founder of the fund meets those definitions.*
33	**Retail corporate bond market** *Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds.*
34	**Unfair contract term provisions** *Support Government's process to extend unfair contract term protections to small businesses.* *Encourage industry to develop standards on the use of non-monetary default covenants.*
35	**Finance companies** *Clearly differentiate the investment products that finance companies and similar entities offer retail consumers from authorised deposit-taking institution deposits.*
36	**Corporate administration and bankruptcy** *Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.*
37	**Superannuation member engagement** *Publish retirement income projections on member statements from defined contribution superannuation schemes using ASIC regulatory guidance.* *Facilitate access to consolidated superannuation information from the ATO to use with ASIC's and superannuation funds' retirement income projection calculators.*
38	**Cyber security** *Update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation, and progress public-private sector and cross-industry collaboration.* *Establish a formal framework for cyber security information sharing and response to cyber threats.*
39	**Technology neutrality** *Identify, in consultation with the financial sector, and amend priority areas of regulation to be technology neutral.* *Embed consideration of the principle of technology neutrality into development processes for future regulation.*
40	**Provision of financial advice and mortgage broking** *Rename 'general advice' and require advisers and mortgage brokers to disclose ownership structures.*
41	**Unclaimed monies**

	Define bank accounts and life insurance policies as unclaimed monies only if they are inactive for seven years.
42	**Managed investment scheme regulation** *Support Government's review of the Corporations and Markets Advisory Committee's recommendation on managed investment schemes, giving priority to matters relating to:* • *Consumer detriment, including illiquid schemes and freezing of funds.* • *Regulatory architecture impeding cross-border transactions and mutual recognition arrangements.*
43	**Legacy products** *Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.*
44	**Corporations Act 2001 ownership restrictions** *Remove market ownership restrictions from the Corporations Act 2001 once the current reforms to cross-border regulation of financial market infrastructure are complete.*

Tax Issues

In relation to tax matters, the FSI Final Report stated the following:

The Inquiry has identified a number of taxes that distort the allocation of funding and risk in the economy. The Inquiry also identified other tax issues that may adversely affect outcomes in the financial system. Unless they are already under active Government consideration, the tax issues listed below should be considered as part of the Tax White Paper process. (Only some issues have been repeated below)

	Tax Issue
a	**Differentiated tax treatment of savings** *Some forms of saving are treated by the tax system more favourably than others. For example income from bank deposits and fixed-income securities are taxed relatively heavily, which makes them less attractive and increases the cost of this type of saving. This distorts asset composition of household balance sheets.* *A more neutral tax treatment would likely increase productivity.*
b	**Negative gearing and capital gains tax** *Reducing capital gains tax concessions would lead to a more efficient allocation of funding in the economy.* *The tax treatment of negative gearing can increase the after-tax return above the pre-tax return.* *Tax treatment of investor housing tends to encourage leverage and speculative investment which is a potential source of systemic risk for the financial system and the economy.*
c	**Dividend imputation** *The case for retaining imputation is less clear than in the past. The introduction of dividend imputation reduced the boas towards debt funding and contributed to the general decline in leverage among non-financial corporates.* *However, as Australia's economy becomes more open and connected to global capital markets*

	the benefits of imputation may have declined. Imputation creates a bias for domestic investors to invest in domestic equities. *The full refunding of credits which exceed tax payable has negative consequences for Government revenue.*
d	**Tax treatment of superannuation Tax concessions** *Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy.* *It also contributes to the broader problem of policy instability.*
e	**Tax treatment of superannuation: Differentiated tax rates on earnings** *Earnings are taxed at 15% in the accumulation phase, but are untaxed in the retirement phase. This can act as a barrier to funds offering 'whole-of-life' superannuation products and increases costs in the superannuation system.*
f	**Goods and services tax (GST)** *GST is not levied on most financial services. This may contribute to the financial system being larger than it otherwise would be.* *Financial service providers that do not charge GST still must pay GST on inputs, but cannot claim input tax credits. Providers pass the cost on to consumers in the form of higher prices.* *Households could therefore be over-consuming financial services compared to what they would consume if GST was applied to these services. Because GST is embedded in prices charged to businesses, but not charged explicitly, businesses cannot claim input tax credits. This could result in businesses consuming fewer financial services than otherwise would be the case.*

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